TAXATION BY THE STATES OF UNITED STATES BONDS HELD BY CORPORATIONS.

FOR the first time in the past half century, the United States has been compelled to exercise to its full xtent the constitutional power "to borrow money upon the credit of the United States;" and at the same time both Federal and State Governments are facing situations which will make heavy demands upon the tax-paying power of their people, so that conflict between the two powers in the effort to find new sources of revenue is inevitable. Hitherto our strength—or perhaps our weakness—has been in the fact that the growth of the country has been so rapid that a tax laid sufficient for the present needs, would produce a surplus in a few years; but we can hardly hope for such relief in the future. We have reached man's estate; and although we will doubtless still grow, it will not be with the magic speed that marked the development of the country between the Appalachians and the Mississippi in the years following the War of 1812, or the settlement of the West following the Civil War. If we are to preserve our reputation as a debt paying nation, we must prepare to lay upon ourselves taxes that will be a real burden. Since the adoption of the 18th Amendment, there is no hope that a new Hamilton can suggest so pleasant an expedient as "drinking down the national debt;" and even if we had not turned virtuous, so that there may "be no more cakes and ale," twenty-five billions is perhaps more debt than even the stoutest nation might drink down.

For many years to come a large portion of the invested wealth of the country will be in securities of the United States, and therefore declared to be exempt from taxation at the hands of the States.

The Constitution of itself contains no express limitation that prevents taxation by the States of securities issued by the United States. The Federal Government is given power to borrow money; and according to Justice Marshall, this grant of power

would be vain if the States had retained the right to levy a tax upon the securities evidencing the debt so created, for by this tax the obligations of the United States might be driven from the market by the States. This principle, that Federal agencies were by implication free from State taxation, was first announced in the case of McCulloch *v.* Maryland.[1] The Court in that case held that the State of Maryland could not lay a tax upon the operation of a bank chartered by the United States in furtherance of its governmental powers. In the course of his opinion, the Chief Justice remarked "as to the bank stock belonging to its citizens it still continues liable to state taxation, as a portion of their individual property in common with all other private property in the State."

Applying this statement strictly it would seem difficult to avoid the conclusion that United States bonds in the hands of individuals would be taxable as a portion of their individual property; but in Weston *v.* Charleston[2] a different conclusion was reached. The City of Charleston required the listing of United States bonds for taxation, and the Supreme Court of the state upheld the tax; but on appeal the Supreme Court of the United States held that these securities were absolutely and for all purposes beyond the power of state taxation. The law attacked in this case required the listing and assessment of personal estate consisting of, "bonds, notes, insurance stock, and six or seven per cent. stock of the United States, or other obligations upon which interest has been or will be received during the year, over and above the interest which has been paid, (funded stock of this State and stock in the incorporated banks of this State and the United States Bank excepted)." This case, therefore, presented squarely the question whether or not a State could by a tax virtually deprive the Federal Government of power to borrow money within its jurisdiction by discriminating between its own bonds and those of the Federal Government. The reason upon which the decision rested was that if a State could tax the bonds at all it could tax without limit; and if this were done bonds would be driven from the market entirely.

[1] 4 Wheat. 316.

[2] 2 Pet. 449.

This case arose when the bonds issued during the War of 1812 were still in the market, and it is interesting to note that the Supreme Court of South Carolina speaks of the fact that the total of bonds outstanding amounted to $100,000,000, and expresses a fear that if so large a volume of wealth should be withdrawn from State taxation, there would not remain sufficient taxable wealth to enable the States to support themselves.

The above decision rested upon the principle that the tax was laid upon the bonds as such, and there was no discussion of the application that should be given the rule in cases where the citizen was assessed for taxation upon his net worth. Probably this was because very little of the wealth of the country was then evidenced by what is now called intangibles and the Court did not foresee the difficulties that would arise in applying the rule; but as the financial and industrial life of the country became more active, such forms of assessment became more common.

An interesting series of cases arose in New York just before the outbreak of the Civil War. The state law required that all chartered banks should be assessed for taxation upon the basis of the value of their capital less real estate owned, without regard to how it was invested. The Bank of the Commonwealth had a capital of $750,000 fully paid, real estate amounting to $188,834.84, and $103,000 in United States bonds. It was assessed, by the Commissioners of taxation for the City of New York, upon its capital valued at $561,165.16. The Bank contended that from this value the amount of United States bonds held by it should also be deducted.

The New York Court sustained the assessment.[3] The Court distinguished the case from Weston *v.* Charleston[4] upon the ground that the tax was not upon the bonds but was an assessment upon capital generally, the value of which was only partially dependent upon bonds, and there was therefore no discrimination against the bonds. The Supreme Court of the United States overruled and reversed this decision[5] holding that a tax upon capital invested in bonds was to that extent a

[3] People *v.* Commissioners of Taxes, 23 N. Y. 192.

[4] *Supra.*

[5] Bank Tax Case, 2 Wall. 200.

tax upon the bonds, and that the value of the bonds must be deducted before the assessed value was determined. Neither the State nor Federal Court discussed the question as to how it was to be determined that bonds held by a bank were to be considered as its original capital. Thus if the bank received deposits, it would be very evident that the capital paid in would be only one item of its resources, and it would be impossible to determine whether the bonds represented the investment of its original capital, or the money which it held due to depositors. The reason for this was probably due to the fact that under the banking system then prevailing, banks were, prior to beginning business, required to place their capital in certain classes of investments. The capital thus invested formed the security for the circulating notes which the banks issued, and therefore it was held separate from their other resources, so that it was always considered a special and earmarked fund capable of identification, and the bonds were considered as the investment of this particular fund, and not merely as one item of the total resources of the bank. The same rule announced in this case had been previously laid down in an earlier case[6] which also concerned a New York City bank in which the facts were essentially similar to the one above.

The decision above cited seemed to make it clear that all United States securities must be deducted from any assessment made of corporate capital; and the rule was followed in many state jurisdictions; but the States continued their efforts to reach the wealth thus invested. Statutes in Connecticut and in Massachusetts imposed a tax upon non-stock savings banks determined by the amount of their deposits. The Connecticut statute imposed a tax upon all savings banks equal to ¾% on the total deposits on hand July 1st, 1863. In the case of Society for Savings *v.* Coite,[7] which arose under this statute it appeared that the plaintiff had deposits amounting to $4,758,273.37, of which $500,161 was invested in bonds of the United States, declared by Congress to be exempt from all State or local taxation.

[6] Bank of Commerce *v.* City of New York, 67 U. S. 620.
[7] 6 Wall. 594.

The assessment was sustained upon the ground that the tax was upon the privilege of exercising a corporate franchise, and the method of assessment was a correct and equitable way of determining that value. The Massachusetts law was substantially similar, except that the basis of taxation was the average amount of deposits during the year. This law was upheld in Provident Institution for Savings *v.* Massachusetts.[8] In both cases it was apparent that, since these corporations had no stock, the total of their deposits must of necessity equal the total of their property, unless they had accumulated some surplus as a reserve against losses, and if such surplus existed it was not mentioned in either opinion. It is impossible to establish any material distinction in results between the tax sustained in these cases, and the tax held to be an interference with the borrowing power of the United States in the former cases. The only distinction that the Court attempts to point out is the fact that the tax sustained is a franchise tax, and the one held invalid a tax upon the capital of a corporation.

A later case, which presents even more striking similarity to the Bank Tax Case,[9] was Hamilton Mfg. Co. *v.* Massachusetts.[10] The plaintiff corporation had a net capital amounting to $276,600, and held among its assets $300,000, par value, United States bonds. A tax one-sixth of one per cent. upon the market value of its stock, which was taken to be equal to the net amount of its capital, levied upon the corporation, was sustained upon the ground that it was a franchise tax, or an indirect tax upon the shares. Whatever may be the technical distinction between a tax upon a franchise and a tax upon property, it is perfectly evident that a tax of a certain fixed per cent of its capital, levied upon a corporation, and a tax *equal to* a certain fixed per cent of its capital, levied upon a corporation as a tax *upon its franchise* have no real difference in effect. In either case the tax is the same, and the corporation which held United States bonds would have no advantage over the corporation which held private securities paying a higher rate of interest.

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[8] 73 U. S. 611. [9] *Supra.* [10] 73 U. S. 632.

Perhaps the real *ratio decidendi* of these cases is to be sought, not in the reasoning of the Court, but in the history of the time. When the New York bank cases reached the Supreme Court, the nation had just ended the doubtful struggle of the War between the States; and there was a very evident reason to encourage in every possible way the purchase and holding of United States bonds. New York City was notoriously suspected of disloyalty, and, therefore, it was doubly desirable to shield from hostile treatment at the hands of the local tax assessors, and to give every advantage to the banks which had invested in Government securities. When the franchise tax theory was adopted in 1867, the War was over, and United States bonds at greatly depreciated prices were being absorbed in large amounts by wealthy individuals and corporations and there was therefore a strong feeling that these speculators should not be allowed to escape taxation. Unfortunately, however, the distinction between a franchise tax determined by the amount of capital or income, and a tax upon the capital or income itself has been the basis of a decision in many later cases, and is now deeply rooted in our constitutional law. However, the more the Courts point out how clearly established the distinction is the less willing they appear to point out what the difference in effect is. In Home Bank *v.* Des Moines,[11] the Supreme Court held the tax there levied to be a tax upon the property of the corporation, and not a tax upon its shares or franchise measured by the value of its property. In the opinion most of the above mentioned franchise tax cases were cited but not discussed, the Court contenting itself with saying, "The theory of all these cases is that the taxes are not imposed upon the assets of the corporation——but upon the franchise."

If this distinction between a franchise tax, and a tax upon property is to be adhered to, the conclusion is unadvoidable that States which desire to drive United States bonds from the hands of corporations within their jurisdiction and so make way for their own state and municipal bonds will be free to do so by the simple expedient of levying franchise taxes graded upon capital

[11] 205 U. S. 503.

or income but permitting deduction for State and municipal bonds held and permitting none for United States bonds. When we consider the large number of corporate investors, insurance companies, savings banks, and similar organizations which will naturally hold such bonds, and the fact that the present United States bond pays a higher rate than many state bonds paid prior to the war, it is easy to foresee that the tendency of State legislation will be to deprive United States bonds of every possible advantage which they may have over State bonds.

It would appear wise for Congress to attempt to meet this situation by legislation. If, as the earlier cases held, obligations of the United States are exempt from all local taxation by virtue of the implications of the Constitution itself, it would appear evident that Congress could not enlarge the exemption; but the Supreme Court has shown an increasing tendency to permit Congress, acting under the power to make laws necessary for carrying into effect the powers granted to the Federal Government, by its own legislation to define the powers of the Federal Government. In the case of McCulloch *v.* Maryland,[12] the Chief Justice declared that the stock of a bank in the hands of the individual citizen was taxable as property. If this had been adhered to it would be inevitable that the State could determine the manner of assessment and the rate of the tax, and could lay a higher rate upon it than upon other property of similar kind; but section 5219 of the Revised Statutes has defined the power of the State governments to tax the shares of national banks, and the numerous decisions applying this section have established that Congress has the undoubted right to regulate the taxation of shares of national bank stock, and in fact the courts have declared that the sole right of the States to tax such stock at all depended upon the permission to that effect contained in the section. In the case of Hanover Bank *v.* Commissioners,[13] it was held that capital of banks invested in bonds of the United States issued prior to 1862 was taxable as other capital, but that bonds issued since the Act of February 1862 could not be included as taxable, because of that Act of Congress which de-

[12] *Supra.*

[13] 37 Barn. 635.

clared them exempt from all taxation, thereby recognizing the power of Congress to legislate on the subject. This case was decided prior to the decision of the Bank Tax Case, and the effect of the rule established in that case which held that no bonds of the United States could be included in taxable capital nullified the New York décision. It appears likely, however, that since for the reason stated the power of the United States to exempt its bonds from state taxation will be rendered ineffective if the States are to be permitted to levy under the guise of franchise taxes, burdens upon the principal and interest of bonds issued by the Federal Government, that Congress has the right by statute to forbid any State to require the principal or interest of United States bonds to be included in capital or income which is made the basis upon which a franchise tax is determined.

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